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Client Advisory

New Jersey Enacts Tax Legislation Designed to Lessen the Impact of the Federal Limitation on State and Local Tax Deductions

On January 13, 2020, Governor Murphy signed into law a bill which is intended to give the owners of LLCs, S corporations and partnerships (“pass through entities”) a way of avoiding some of the impact of the federal government’s limitation on the deduction for state and local taxes.

For 2018 and years thereafter, the federal deduction for state and local taxes is limited to \$10,000 per year. Several states (New Jersey included) have been trying to find a way around that rule for the benefit of their taxpayers, and with this new law, New Jersey joins at least two other states which have enacted similar legislation.

Subject to a limited exception, pass through entities themselves do not pay New Jersey income taxes on their taxable income. Instead, the entities’ income “passes through” and is taxed to its owners. The key to understanding the new legislation is this: the New Jersey income tax which owners pay on their flow through income is one of the taxes which counts toward the \$10,000 federal limit.

Under the new law, pass through entities will have the option of paying New Jersey state income taxes at the entity level (as though it were a business tax), in lieu of paying them at the owners’ level (which is what makes them a personal income tax subject to the \$10,000 limitation). By characterizing the tax as a business tax, the pass through entity’s taxable income will be reduced by the amount of the tax. That will result in a correspondingly lesser amount of flow through income to be taxed to the owners at the federal level, thereby effectively allowing the owners the benefit of a deduction for the New Jersey taxes without subjecting those taxes to the \$10,000 limit.

Query: is the IRS going to respect this? Proponents of the legislation would lead one to believe that the IRS would have a difficult time challenging the treatment sought by the Legislature and the Governor. Indeed, it might. That being said, we remind people of two general truths: (i) if it sounds too good to be true, it

probably is; and (ii) federal tax laws generally do not allow taxpayers to do indirectly that which they cannot do directly. Time will tell.

The new entity-level tax is known as the “pass-through business alternative income tax” and is effective for taxable years of pass through entities beginning on or after January 1, 2020.

The option to pay the tax at the entity level is an annual one - - an LLC, for example, may make the election one year, but not the next. It must be made by all members of the entity or by any officer, manager or member of the entity who is authorized to make the election on behalf of the entity.

The tax rates imposed at the entity level are not identical to the rates imposed on individuals. Prior to making the election, therefore, business owners should consult with their tax advisors to determine the benefit, if any, of making the election.

We hope this is helpful. If you have any questions, do not hesitate to contact [Gordon Moore](#), who heads up our [Tax Group](#), at (856) 354-3087 or at gmoore@archerlaw.com, or any of your contacts here at Archer.

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